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IN THE

Supreme Court of the United States

October Term, 1972

No. .....

GILBERT ROBINSON,

Petitioner,

vs.

BURTON FRASHER and KAY FRASHER,

Respondents.

In the Matter of

FRASHER'S, INC., a California corporation,

Bankrupt.

Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner Gilbert Robinson, trustee in bankruptcy for Frasher's, Inc., a California corporation, bankrupt, being aggrieved by orders of the United States Court of Appeals for the Ninth Circuit, respectfully petitions for a Writ of Certiorari to reverse the judgments and opinions of the United States Court of Appeals of the Ninth Circuit entered in this proceeding on the 24th day of March, 1972 and the 5th day of May, 1972.

Opinion Below.

The Findings of Fact, Conclusions of Law and Order of the Honorable Joseph J. Rifkind, Referee in Bankruptcy, filed January 20, 1970 (Appendix A, *infra*, p. 1) is not reported.

The Order of the District Court, entered June 3, 1970 (Appendix B, *infra*, p. 3) is not reported.

The opinion of the Ninth Circuit Court of Appeals, entered March 24, 1972, and as modified on May 5, 1972 (Appendix C, *infra*, p. 4), is not yet reported.

Jurisdiction.

The judgment of the Court of Appeals, Ninth Circuit, was entered on the 24th day of March, 1972. The Order of the same Court modifying its previous opinion in part, but otherwise denying the petition for rehearing was entered on May 5, 1972. The Order of the District Court causing the judgment of the Court of Appeals to be filed and spread upon the minutes of the District Court was entered June 7, 1972. This petition for Writ of Certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1) and § 24c of the Bankruptcy Act (11 USC § 47(c)).

Questions Presented.

It is respectfully submitted that the following questions are before this Court:

1. Should the claim of the controlling shareholders', against their bankrupt corporation, representing a personal loan to said corporation, be subordinated to the claims of mercantile trade creditors where, while in the absence of fraud, the loan was made at a time when the corporation was undercapitalized and the loan was found by the Referee to be an addition to capital? In other words, are "risk investments" by entrepreneurs to be treated on a parity with trade creditors shipping on open account?

2. Should the wage claims of the controlling shareholder against his bankrupt corporation be subordinated to the claims of other creditors where said shareholder refrained from drawing the wages during a period when the corporation was undercapitalized?

Statutory Provision Involved.

Bankruptcy Act, § 2(a), (11 USC 11(a)), provides as follows:

> "The courts of the United States hereinbefore defined as courts of bankruptcy are hereby created courts of bankruptcy and are hereby invested within their respective territorial limits as now established whereas they may be hereafter changed, with such jurisdiction at law and in equity as will enable them to exercise original jurisdiction in proceedings under this Act . . ."

Statement of the Case.

Respondents, Burton Frasher and Kay Frasher are husband and wife. Since 1956, they have been and now are majority stockholders of the bankrupt corporation, owning 57.6% of the issued and outstanding corporate stock. Also since 1956, Burton Frasher has been president and his wife, Kay Frasher, has been Vice President and Treasurer. They have also been members of the Board of Directors of the bankrupt. In their respective capacities, Burton Frasher and Kay Frasher were in control and managed the affairs and operations of the corporation during the period when the obligations set forth in the bankrupt's schedules were incurred.

According to its corporation minutes, the bankrupt began experiencing financial difficulties as early as December 31, 1959. Due to the failure of institutional lenders to grant new loans to the bankrupt, the bankrupt (*i.e.* the Frashers) sought loans from internal sources. Pursuant to the June, 1964 authorization of the Board of Directors of the bankrupt for the issuance of a promissory note, the bankrupt obtained from the Frashers (respondents) the sum of $13,000, which the Referee found not to be a loan, but intended and utilized as an addition to the capital of the bankrupt at a time when there was a conceded need of $40,000 for additional capital.

Burton Frasher was actively engaged in the management (*i.e.*, doing all hiring, firing, purchasing, payment of accounts payable, etc.) of the bankrupt as the managing employee since 1962. In such capacity, Burton Frasher earned the wages which were not drawn and which became the basis of one of his claims against the bankrupt.

The bankrupt filed its voluntary petition in bankruptcy on August 21, 1967 in the United States District Court, Central District of California, which Court had jurisdiction pursuant to § 2 of the Bankruptcy Act (11 USC § 11). Respondents, Burton and Kay Frasher, filed a Proof of Claim in Bankruptcy in the sum of $11,947.41, representing the balance on the unsecured loan to the corporation. Burton Frasher also filed a Proof of claim in Bankruptcy in the amount of $522.84, representing wages.

The trustee in bankruptcy duly filed objections to these claims, one of the grounds for said objection being that at the time the alleged loan was made and

wages were left not drawn, the bankrupt corporation was undercapitalized and in need approximately $40,000 additional capital, and that said claims should therefore be subordinated to the payment of the claims of other creditors.

The Honorable Joseph J. Rifkind, Referee in Bankruptcy, made an Order on January 20, 1970, subordinating said claims to the payment of the claims of other creditors, which order was affirmed by the Honorable Harry C. Westover, Judge, United States District Court, Central District of California, on June 3, 1970. The United States Court of Appeals for the Ninth Circuit reversed the Order and remanded the cause so as to permit the District Court reopen the cause for the purpose of determining the existence of inequitable conduct.

ARGUMENT.

A review of Writ of Certiorari is sought in this matter for the reasons that the United States Court of Appeals for the Ninth Circuit has rendered a decision in conflict with the decision of another Court of Appeals on the same matter, which matter is an important question of Federal law which has not been, but should be, settled by this Honorable Court.

As submitted above, the questions of Federal law involved in this matter are whether shareholders' claims against their bankrupt corporation, representing advances to their corporation and wages not drawn, should be subordinated to the claims of other creditors, where, while in the absence of fraud, the loan was made and wages were not drawn during the period when the corporation was undercapitalized and the loan was found by the Referee to be an addition to capital. The Ninth Circuit Court of Appeals' resolution of the matter was that "absent inequitable conduct, *bona fide* claims based upon loans from majority shareholders will not be subordinated to the claims of other creditors." (Appendix C, p. 4).

The decisions of the various Courts of Appeals are in conflict with one another and with the dicta found in previous decisions of this Honorable Court, as to the implementation of the recognized equity powers of the Courts of Bankruptcy under § 2 of the Bankrupt Act (11 U.S.C. § 11). See *Pepper v. Litton*, 308 U.S. 295 (1939); *Local Loan Co. v. Hunt*, 292 U.S. 234 (1933). In *Pepper v. Litton, supra*, this Court held that a bankruptcy court is justified in disallowing or subordinating the salary claims of a dominant and controlling stockholder of a bankrupt corporation where,

as part of a planned and fraudulent scheme to defeat creditors of the corporation, he permitted his claims to lie dormant for years. Justice Douglas delivered the opinion of the Court, and in noting a number of situations in which fictitious or sham claims will be disallowed or subordinated, stated:

> "And so-called loans or advances by the dominant or controlling stockholder will be subordinated to claims of other creditors and thus treated, in effect, as capital contributions by the stockholder, not only in the foregoing types of situations, but also where the paid in capital is purely nominal, the capital necessary for the scope and magnitude of the operation of the company being furnished by the stockholder as a loan." *Pepper v. Litton, supra,* 308 U.S. 309-310.

The decisions of the United States Court of Appeals for the Fourth Circuit represent the clearest line of authority that fraud and mismanagement need not always be present in order that claims may be subordinated in a situation involving undercapitalization. For example, in *International Telephone and Tel Corp. v. Holton,* (4th Cir. 1957) 247 F. 2d 178, the Fourth Circuit held that claims of a parent corporation should be subordinated, even without proof of fraud or illegality, where the subsidiary corporation is initially undercapitalized and controlled by the parent for its own purposes. Similarly, in *Jewell Ridge Coal Corporation v. C. I. R.,* (4th Cir. 1963) 318 F. 2d 695, the Court cited *Pepper v. Litton, supra,* 308 U.S. at 309 and stated, . . .

> "the vast disproportion of the amount concededly paid by *Jewell* as capital . . . and the alleged

loan . . . renders these amounts suspect as loans. While *Jewell* and its officers are altogether innocent of even intimation of any misdoing or ulterior motive, the relationship of the financier to the finance objectively throws doubt upon these funds as loans."

Other decisions and opinions supporting the proposition that undercapitalization alone may serve as the basis for subordinating claims by controlling shareholders based on loans are: *L & M Realty Corporation v. Leo,* (4th Cir. 1957) 249 F. 2d 668; *Boyum v. Johnson,* (8th Cir. 1942) 127 F. 2d 491; *Comstock v. Institutional Investors,* 335 U.S. 221 (1948), diss. opinion of Justice Murphy, in which Justices Black, Douglas and Rutledge concurred.

Conversely, the position of the Third and Fifth Circuits is that a showing of inequitable conduct is an *absolute and necessary* prerequisite to the subordination of claims of majority shareholders based upon loans. *In re Calpa Products Company,* (E.D. Pa. 1965) 249 F. Supp. 71, aff'd 354 F. 2d 1002 (3rd Cir. 1965), cert. denied sub nom. *Grasberger v. Calisi,* 383 U.S. 947 (1966), rehearing denied 384 U.S. 934 (1966), the Court cited *Gannett Co. v. Larry, supra,* in supporting its conclusion that "unless there is support for a finding of inequitable conduct beyond mere relationship between claimant and bankrupt, the subordination of claims cannot stand." See also *Spach v. Bryant,* (5th Cir. 1962) 309 F. 2d 886; and *cf. In re Madelaine, Inc.,* (2nd Cir.) 1964 F. 2d 419; *Comstock v. Institutional Investors, supra.* While these decisions do not, for the most part, directly involve the problem of undercapitalization, to the extent that they require

a showing of fraud, illegality, or other inequitable conduct, as a prerequisite to subordination, they are in conflict with the decisions previously noted.

The Ninth Circuit Court of Appeals formerly adhered to the position that fraud and mismanagement need not always be present if claims are to be subordinated in a situation involving undercapitalization. See *Costello v. Fazio*, (9th Cir. 1958) 256 F. 2d 903. However, upon the Ninth Circuit's reversal of the Honorable Referee and the District Court for the Central District of California in this matter, it would appear that if a majority shareholder advances money to his undercapitalized corporation and the money is used as an addition to capital, the Ninth Circuit will nonetheless require a showing of fraud or other inequitable conduct before subordinating the majority shareholder's claims to the claims of mercantile creditors.

The importance of a resolution of this matter by this Honorable Court is underscored by a recognition by the inequities which result when majority shareholder succeed on claims based on "loans" which were, in fact, contributions to capital. Numerous advantages and benefits, included limited liability, are accorded those who assemble and commit "risk capital" to an economic venture. If majority shareholders are permitted to characterize their contributions as "corporate capital" for the purposes of limited liability and profit sharing, and at the same time as simple "loans" for the purpose of recovering on a parity with mercantile creditors who, unfortunately, extended trade credit based upon the false facade of the "contributions", then undue advantage is given to the shareholders at the expense of creditors.

This inequity was perhaps best described by Judge Learned Hand in his concurring opinion in *In re Loewer's Gambrinus Brewery Co., supra,* 167 F. 2d at 320:

> "Both the shareholders and the creditors in any enterprise assume some risk of its failure, but their risks are different. The shareholders stand to lose first, but in return they have all the winnings above the creditors interest, if the venture is successful; on the other hand, the creditors have only their interest, but they come first in distribution of the assets. Beneficially considered, the same person are both creditors and shareholders, when they have organized into two corporations under a single control. If, in such a case they are allowed to prove an insolvency on a parity of other creditors, as shareholders of the debtor they can use their control to take all the winnings which may be made on their advances while the company is successful, yet they will expose themselves only to creditor's risk, if it fails. That is unfair to other creditors, regardless of whether they know that the shareholders of the debtor corporation have their power through their common ownership; for every creditor rightly assumes that his risk is measured by the collective claims of the other creditors, and by creditors he understands those alone, who like him, have only a stipulated share in the profits. To compel him to divide the assets in insolvency with those who at their option have all along had power to take all the earnings, to add to the risk which he accepted."

Petitioner therefore respectfully submits that this case presents this Honorable Court with an opportunity to decide an important question of Federal law which has not been, but should be, settled by this Honorable Court, which resolution would end the current conflict among the various Courts of Appeals. The Petitioner therefore prays that a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit be granted.

Dated: September 6, 1972.

SPRAGUE & CLEMENTS,
By RICHARD R. CLEMENTS,
Attorneys for Petitioner.

APPENDIX A.

Findings of Fact, Conclusions of Law on Objections to Claims Nos. 174 and 176.

United States District Court, Central District of California.

In the Matter of Frasher's Inc., a California corporation, Bankrupt. In Bankruptcy No. 20650.

The matter of the Trustee's objections to Claim No. 174, of Burton Frasher, in the sum of $522.84, filed as a priority claim, and Claim No. 176, of Burton and Kay Frasher, in the sum of $11,947.41, as a general unsecured claim, coming on regularly for hearing upon November 19, 1969, at 10:00 o'clock, A.M., before the HONORABLE JOSEPH J. RIFKIND, Referee in Bankruptcy, and Sprague and Clements, by Richard R. Clements, appearing upon behalf of the Trustee upon each of said matters, and Stanley O. Epstein, appearing on behalf of each of said claimants upon each claim and oral and documentary evidence having been introduced upon behalf of both parties upon each of said claims and the objections thereto, and the Court having considered the same and heard the arguments of counsel, and being fully advised, makes the following findings of fact and conclusions law:

FINDINGS OF FACT

1. That Burton Frasher and Kay Frasher were, at all times pertinent hereto, husband and wife and have been (in the aggregate) the majority shareholders of the bankrupt since 1956. Since that year, Burton Frasher has been the president of the bankrupt, and Kay Frasher appears as the vice-president and treasurer of the bankrupt in the minutes of the corporation since

1962. That the minutes of the corporation reflect that the bankrupt has experienced financial difficulty in the repayment of its loans as early as December 31, 1959, so that the bankrupt sought loans from internal sources, (such as trust controlled by the claimant, Kay Frasher, and as evidenced by Claim No. 175 on file herein, and from employees of the bankrupt, as evidenced by Claim No. 194, filed herein). That both Burton and Kay Frasher appeared to be members of the Board of Directors of the bankrupt since 1962. That Burton Frasher was actively engaged in the management of the physical facilities of the bankrupt as the managing employee since 1962.

2. That the indebtedness in question commenced on August 20, 1964, and the bulk of said indebtedness was utilized, by the bankrupt, as an addition to his capital.

3. That Claim No. 174, filed by Burton Frasher, in the amount of $522.84, as a priority wage claim, is for services rendered to the bankrupt within a period of 90 days prior to the filing of its voluntary petition.

CONCLUSIONS OF LAW

4. That Claims Nos. 174, 176, and each of them, should be subordinated to the payment of all priority and general claims.

DATED: January 20, 1970.

/s/Joseph J. Rifkind
Referee in Bankruptcy

APPENDIX B.

Order and Judgment Affirming Referee's Findings of Fact, Conclusions of Law and Order of January 20, 1970.

United States District Court, Central District of California.

In the Matter of Frasher's, Inc., a California corporation Bankrupt. In Bankruptcy No. 20650.

Entered: June 3, 1970.

The review of the Referee's Findings of Fact, Conclusions of Law, and Order of January 20, 1970, upon the petition of Burton Frasher and Kay Frasher, having been heard on May 20, 1970, before the court, the Honorable Harry C. Westover, United States District Court Judge, Presiding, and petitioners Burton and Kay Frasher being represented by Stanley O. Epstein, and respondent, Gilbert Robinson, being represented by Sprague and Clements, by Richard R. Clements, and issues having been duly heard and a decision having been duly rendered, it not appearing to the court that the Referee was clearly erroneous in his determination that the claims of petitioners should, equitably, be subordinated to the payment of all mercantile and trade creditors of the bankrupt corporation, the court finds that the Petition for Review should be denied, and therefore it is

ORDERED AND ADJUDGED that the Referee's Findings of Fact, Conclusions of Law, and Order of January 20, 1970, be and hereby is affirmed in its entirety.

DATED: This 3rd day of June, 1970.

HARRY C. WESTOVER
United States District Judge

APPENDIX C.

Appeal From the United States District Court for the Central District of California.

In the United States Court of Appeals, for the Ninth Circuit.

Burton Frasher and Kay Frasher, Creditor Claimants-Appellants, v. Gilbert Robinson, Trustee-Appellee.

In the Matter of Frasher's Inc., a California corporation, Bankrupt. No. 26,201.

Filed: March 24, 1972.

Before: ELY, HUFSTEDLER and WRIGHT, Circuit Judges.

PER CURIAM:

Burton Frasher and his wife were majority shareholders in Frasher's Inc., a retail stationery and camera business. Frasher was president of the corporation and active in its management; Mrs. Frasher was vice-president and treasurer.

In 1967 the company filed a voluntary petition in bankruptcy. The Frashers were listed as creditors in the amount of $11,947.41 (balance due on an unsecured installment loan). Frasher was listed as a creditor in the amount of $522.84 (wages due).

The referee subordinated both of the Frasher claims to the claims of all of the general creditors, on the ground that the Frashers were majority shareholders. The district court affirmed.

Claims of majority shareholders will be subordinated when the majority shareholders have been involved in fraud, overreaching, or other inequitable conduct. *Pepper v. Litton*, 308 U.S. 295 (1939).

However, absent inequitable conduct, *bona fide* claims based upon loans from majority shareholders will not be subordinated to the claims of other creditors. *Comstock v. Group of Investors*, 335 U.S. 211 (1948); *In Re Calpa Products Company*, 249 F. Supp. 71 (E.D.Pa. 1965), *aff'd* 354 F.2d 1002 (3rd Cir. 1965), *cert. denied sub nom. Grasberger v. Calissi*, 383 U.S. 947 (1966), rehearing denied 384 U.S. 934 (1966); *Spach v. Bryant*, 309 F.2d 886 (5th Cir. 1962); *Gannett Co. v. Larry*, 221 F. 2d 269 (2d Cir. 1955); *Theriot v. Plane*, 126 F.2d 1015 (9th Cir. 1942). In this case, there being no showing of inequitable conduct, it was error to subordinate the Frasher installment loan claim.

The referee determined that the Frasher wage claim was not entitled to priority status as wages due to "workmen, servants, clerks, or traveling salesmen" under 11 U.S.C. §104(a)(2). This was correct, based on the referee's finding that Frasher's claim was for management services. Again, however, in the absence of inequitable conduct, the claim should have been accorded equal treatment with other general creditor claims.

Reversed, with instructions to allow the Frasher claims on a parity with those of other creditors of the same class.

Order.

In the United States Court of Appeals for the Ninth Circuit.

Burton Frasher and Kay Frasher, Creditor Claimants-Appellants, v. Gilbert Robinson, Trustee-Appellee.

In the Matter of Frasher's, Inc., a California corporation, Bankrupt. No. 26,201.

Before: ELY, HUFSTEDLER and WRIGHT, Circuit Judges.

Upon petition for rehearing the opinion is modified by striking the final sentence thereof and substituting in lieu thereof the following sentence:

> The order is reversed, and the cause is remanded for further proceedings consistent with the views herein expressed; upon remand, the court may reopen the cause for the purpose of determining the existence of inequitable conduct justifying subordination of the claims in question to the claims of general creditors.

The petition for rehearing is otherwise DENIED.

DATED: